

Fiscal Note

BILL # SB 1783

TITLE: small businesses; alternate income tax

SPONSOR: Mesnard

STATUS: Senate Engrossed

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Description

Beginning in Tax Year (TY) 2021, the bill would provide an option for any qualifying taxpayer to elect to be taxed under either the regular individual income tax (Chapter 10 of Article 43) or the new business income tax (Chapter 17 of Article 43) created by SB 1783. To qualify for the business income tax, an individual's federal adjusted gross income (FAGI) must include one or more of the following income sources:

- Interest and Ordinary Dividends (Schedule B)
- Profit or Loss from Business (Schedule C)
- Supplemental Income or Loss (Schedule E)
- Profit or Loss from Farming (Schedule F)
- Sale of Business Property (Form 4797)
- Farm Rental Income and Expenses (Form 4835)
- Capital Gains and Losses with respect to the taxable disposition of an ownership interest in any business entity other than a publicly traded company, or the taxable disposition of capital assets used in connection with trade or business activity (Schedule D).

FAGI that includes other income sources, such as salaries, pensions, and social security benefits would continue to be taxed under the regular individual income tax. For this reason, if a taxpayer's FAGI includes both business income (as defined above) and regular income (such as salaries and other non-business income), they would be required to file both an "Arizona Small Business Income Tax Return" as well as the standard Individual Income Tax Return (Form 140).

The business income tax would be levied at a flat rate of 4.5%, whereas the regular income tax would continue to be taxed as under current law (i.e., 4 tax brackets with tax rates going from 2.59% to 4.5%). An individual who elects to be taxed under the business income tax (Chapter 17 of Title 43) would not have the new Proposition 208 3.5% surcharge imposed on their business taxable income. All revenues collected under business income tax would be deposited into the General Fund.

Estimated Impact

Assuming that taxpayers would choose to be taxed in a manner that would minimize their individual income tax liability, we estimate that SB 1783 would have no General Fund impact but that it could reduce revenues from the 3.5% surcharge deposited into the newly created "Smart and Safe Arizona Fund" by an estimated \$(527.7) million annually, beginning in FY 2022.

We would note that due to significant data constraints, there is considerable uncertainty regarding the accuracy of our estimate. For this reason, the fiscal impact estimate above should be interpreted cautiously.

The Department of Revenue has not provided their estimate of the bill's fiscal impact.

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Analysis

Income Threshold for Electing the Business Income Tax

A taxpayer whose filing status is married filing jointly would not benefit from the business income tax unless their taxable income is in excess of \$568,417 (the corresponding amount for a taxpayer filing as single is \$284,207). At this income level, the taxpayer's total tax liability (regular tax plus 3.5% surcharge) is equal to \$25,579 [= \$54,544 x 2.59% + (\$109,088 - \$54,544) x 3.34% + (\$327,263 - \$109,088) x 4.17% + (\$568,417 - \$327,263) x 4.5% + (\$568,417 - \$500,000) x 3.5%]. If the taxpayer elected to pay the business income tax, their liability would be the same, or \$25,579 [= \$568,417 x 4.5%]. The effective tax rate at the taxable income level of \$568,417 is 4.5% under both the regular individual income tax, including the 3.5% surcharge as under the proposed business income tax.

We assume that most taxpayers would elect to be taxed under the business income tax only when the combined (regular plus surcharge) effective tax rate is greater than 4.5%. As a result, we have limited our analysis of the bill to taxable income levels above \$568,417 for married couples filing joint returns and \$284,207 for single filers.

Data and Methodology Used for Analysis

We have neither access to detailed federal or state tax return data nor aggregated state filing data by income level. For this reason, we used federal income tax return data published by the Statistics of Income Division of the Internal Revenue Service (IRS). The IRS data is compiled from federal tax returns filed by Arizona residents for TY 2018. The data includes information on the number of filers and dollar amounts by FAGI level. The data is reported as it appears, line by line, on federal income tax return 1040.

The IRS data is reported for 10 different FAGI groups. In terms of our methodology, we used the following approach. First, since the threshold for electing the business tax is taxable income of \$284,207 for single filers and \$568,417 for taxpayers filing jointly, we limited our analysis to the 3 highest FAGI brackets: from \$200,000 to \$500,000; from \$500,000 to \$1 million; and above \$1 million. Second, since the IRS lists FAGI by income source, we estimated the share of FAGI that would meet the definition of business gross income under the bill is 20.2% for the \$200,000 to \$500,000 bracket, 37.0% for the \$500,000 to \$1 million bracket, and 52.2% for the above \$1 million bracket. Third, based on the IRS data, we estimated the average Arizona taxable income for each of the 3 income groups to be \$259,800 for the \$200,000 to \$500,000 FAGI bracket; \$636,500 for the \$500,000 to \$1 million FAGI bracket; and \$2.8 million for the above \$1 million FAGI bracket. (The average Arizona taxable income was estimated by subtracting the average deduction amount (standard or itemized) from the average FAGI for each of the 3 income groups.)

Based on the methodology outlined above, we excluded the \$200,000 to \$500,000 FAGI bracket from our analysis since the average Arizona taxable income of \$259,800 for this bracket is below the business income tax threshold of \$284,207 for single filers and \$568,417 for joint filers.

Estimated Fiscal Impact

As suggested above, only individual income taxpayers in the 2 highest FAGI brackets (\$500,000 to \$1 million and above \$1 million) would benefit from the 4.5% business income tax. While the average Arizona taxable income for the 2 highest brackets is estimated to be \$636,500 and \$2.8 million, respectively, not all that income would qualify as business income. Based on the IRS data described above, we estimate that 63.0% of the \$636,500 in Arizona taxable income (or \$401,300) would be subject to regular income tax as well as the 3.5% surcharge, while the remaining 37.0% (or \$235,200) would qualify under the 4.5% business tax. For the highest income group, we estimate that 47.8% of the \$2,757,800 in Arizona taxable income (or \$1,315,600) would be subject to both the regular income tax and surcharge, whereas the remaining 52.2% (or \$1,442,200) would be subject to the business tax.

FAGI Bracket \$500,000 to \$1 Million

Under current law, a taxpayer filing a joint return with an Arizona taxable income of \$636,500 would have a regular tax liability of \$26,248 [= \$54,544 x 2.59% + (\$109,088 - \$54,544) x 3.34% + (\$327,263 - \$109,088) x 4.17% + (\$636,500 - \$327,263) x 4.5%] plus a surcharge of \$4,778 [(\$636,500 - \$500,000) x 3.5%], for a total liability of \$31,026.

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Under the bill, we assume the taxpayer would elect the 4.5% tax for the portion of the taxable income (37% or \$235,200) that is derived from business income [$\$235,200 \times 4.5\% = \$10,584$] and the regular tax on the remaining portion (63% or \$401,300) of taxable income [$\$54,544 \times 2.59\% + (\$109,088 - \$54,544) \times 3.34\% + (\$327,263 - \$109,088) \times 4.17\% + (\$401,300 - \$327,263) \times 4.5\% = \$15,664$], for a total of \$26,248. This would be same amount as what is paid as regular tax under current law. Therefore, the bill would have no impact on General Fund revenue. Instead, the total average liability loss of \$(4,778) [= \$26,428 - \$31,026] under the bill relative to current law would be solely incurred by the Smart and Safe Arizona Fund under Proposition 208. (Note that since only 12% of taxpayers in this income group are single filers, we simplified our analysis by assuming that all taxpayers filed joint returns.)

Based on IRS data, we estimate that 11,244 tax-filers in the \$500,000 to \$1 million bracket would incur an average liability reduction of \$(4,778), for a total of \$(53.7) million, all of which would affect the Smart and Safe Arizona Fund.

FAGI Bracket Above \$1 Million

Under current law, a taxpayer filing a joint return with an Arizona taxable income of \$2,757,800 would have a regular tax liability of \$121,706 [= $\$54,544 \times 2.59\% + (\$109,088 - \$54,544) \times 3.34\% + (\$327,263 - \$109,088) \times 4.17\% + (\$2,757,800 - \$327,263) \times 4.5\%$] plus a surcharge of \$79,022 [$(\$2,757,800 - \$500,000) \times 3.5\%$], for a total liability of \$200,728.

Under the bill, we assume the taxpayer would elect the 4.5% tax for the portion of the taxable income (52.2% or \$1,442,200) that is derived from business income [$\$1,442,200 \times 4.5\% = \$64,901$] and pay the regular tax on the remaining portion (47.8% or \$1,315,600) of taxable income [$\$54,544 \times 2.59\% + (\$109,088 - \$54,544) \times 3.34\% + (\$327,263 - \$109,088) \times 4.17\% + (\$1,315,600 - \$327,263) \times 4.5\% = \$56,805$], for a total of \$121,706. As in the estimate above, the same amount of regular tax (i.e., \$121,706) would be paid under the bill as under current law, and for this reason SB 1783 would have no General Fund impact. This means that the total average liability reduction of \$(79,022) [= \$121,706 - \$200,728] would be incurred by the Smart and Safe Arizona Fund. (Note that since only 13% of taxpayers in this income group are single filers, we simplified our analysis by assuming that all taxpayers filed joint returns.)

Based on IRS data, we estimate that 5,998 tax-filers in the above \$1 million bracket would incur an average liability reduction of \$(79,022), for a total of \$(474.0) million, all of which would affect the Smart and Safe Arizona Fund.

Based on our analysis of aggregate IRS tax-filing data for the 2 FAGI brackets above \$500,000, we estimate that SB 1783 would reduce revenues generated by the 3.5% surcharge deposited into the Smart and Safe Arizona Fund by \$(527.7) million, beginning in FY 2022. Due to the inherent limitation of using aggregate tax-filing data (as opposed to actual tax return data), there is considerable uncertainty associated with our estimated fiscal impact.

Local Government Impact

Incorporated cities and towns receive 15% of the individual income tax and corporate income tax from the two years prior from the Urban Revenue Sharing Fund (URSF) established by A.R.S § 43-206. Since the bill would not affect state income tax revenues deposited into the General Fund, URSF distributions to cities and towns would be unaffected.

3/2/21